for all services and the total costs of the company in Texas will be at a minimum in the range of 40% to 50%. I would expect Kansas to have shared and common costs in the same range. Pricing services equal to the LRIC or TSLRIC will not allow SWBT to recover significant portions of its costs.

Based on my experience, there is no reason to believe that the results in South Carolina would be substantially different.

Q. PLEASE EXPLAIN WHY SOME COSTS ARE NOT INCREMENTAL TO SERVICES.

A. First, many activities performed by LECs cannot be found to vary with the LECs' scope of services. Examples are activities such as: creating, updating and maintaining large computer systems for customer and network administration; executive, legal and administrative functions, and work pertaining to the corporate entity as a whole. Indeed, extended unresolved disputes about how to fully distribute costs can be explained by a lack of a clear cost causative relationship and the significance of common costs. Thus engineering, economic and activity-based studies do not assign all costs to services.

Second, the very nature of many costs is clearly shared. Resources (such as certain right-to-use fees, computer programming, and general organizational activities) are expended once without the need to expand the scale of activities to accommodate greater volumes of business, including adding products or services.

Q. DO YOU BELIEVE THAT A LEC HAS CHARACTERISTICS WHICH CAUSE IT TO TEND TO HAVE A HIGHER PROPORTION OF COMMON COSTS THAN OTHER BUSINESS ENTERPRISES?

A. Yes, there are several factors which I believe will cause a LEC, like BellSouth, to tend to have a higher proportion of common costs than other business enterprises. These factors include: 1) a large number of services offered; 2) network-based service provision; 3) the ubiquitous placement of facilities over broad geographic areas; 4) large scale and indivisible investment characteristics; 5) predominance of services rather than products; and 6) "leasing" of virtually no unbundled components from other suppliers.

Q. WHAT DO YOU MEAN WHEN YOU SAY LECS ARE "LEASING" VIRTUALLY NO UNBUNDLED COMPONENTS?

A. I have used the term "lease" in a generic sense to mean using the facilities of others (at a price) rather than buying or building one's own facilities. LECs tend to own rather than lease facilities. In contrast, a high proportion of Interexchange Carrier ("IXC") and CLEC costs may be comprised of expenditures to lease facilities from LECs. At one point in time, AT&T claimed that approximately 60% of its toll revenues were paid to LECs for access services. There-

fore, the leasing of LEC facilities (i.e., access payments) became part of the direct cost or incremental cost of AT&T's toll service. A CLEC too may lease a significant proportion of its facilities from LECs and, therefore, will necessarily have a higher proportion of incremental costs and a smaller proportion of joint and common costs, vis-à-vis the LECs.

Q. IF A NETWORK-BASED COMPANY LIKE BELLSOUTH IS REQUIRED TO SET RATES FOR EACH SERVICE JUST SUFFICIENT TO COVER LRIC, TSLRIC OR TELRIC, WILL THAT COMPANY RECOVER ALL OF ITS COSTS?

A. No, it will not. Service prices which only generate total revenue equal to the sum of all service incremental costs will not cover total cost. As I have discussed, there are common costs incurred by a company, especially a multiservice network-based company like BellSouth, which are *not* incremental to any one service, but which are nevertheless valid costs of engaging in its business activities. In total, service revenues must exceed service incremental costs by a margin sufficient to recover all costs of the firm, including the common costs of the firm. Even if it were determined that some costs presently categorized as common were incremental after all, prices would need to cover those higher costs and contribute toward the remaining (non-incremental) costs. To simply assure that each service does not receive a subsidy, by establishing all service prices at,

or slightly above, any measure of incremental costs means that a provider will not recover all of its costs.

Moreover, BellSouth cannot be said to have priced its services to attain a reasonable profit until its prices are set sufficiently above any measure of incremental costs to recover its common costs plus a return. In short, if BellSouth is required to set service prices at any measure of incremental costs, with no provision for common costs, which must necessarily be incurred to provide business services, then it cannot even cover its total costs, much less earn a profit on those services.

Q. CAN YOU ILLUSTRATE THIS POINT WITH A NUMERICAL EXAMPLE?

A. Yes. Consider products A and B each with an incremental cost per unit of $0.25 and with demand of 100 for each service. The incremental cost for the sum of the units demanded is $25.00 for A and $25.00 for B. To produce either A or B, however, the firm must also spend $50.00 per period on a right to use fee, say a computer operating system. In this simple example, the $50.00 is a common cost of these two products. The firm has found a source of economic efficiency: it can produce both A and B spending $50.00 once rather than twice (once for each product). Obviously, if the prices per unit of both services A and B are forced to equal their incremental costs of $0.25, the firm will face a loss of $50.00 per period. Similarly, if the firm is forced to price one of its services at

incremental cost, the firm will face a loss unless it can double the contribution margin on its remaining service. The greater the efficiencies of sharing facilities and costs, the larger the common costs of the firm and the greater the need to price services in excess of incremental cost. In other words, such increased efficiencies will increase common costs, but with a more than offsetting reduction in incremental costs. These larger common costs must be recovered, however, for the firm to remain in business.

Q. ARE SHARED FACILITIES AND COMMON COSTS BENEFICIAL?

A. Yes, the increased efficiencies from sharing facilities and costs is desirable for the firm and desirable for society as well. These costs must be recovered, however, from the services which the firm provides. Forcing service prices to equal any measure of incremental costs does not allow for the recovery of the common costs which are beneficial to society. It is inappropriate to penalize a company for improving its efficiency by not allowing recovery of common costs. To illustrate this, recall products A and B described earlier where the incremental costs per unit for each is $0.25, the common cost is $50.00, and 100 units of each service are demanded. Consider what occurs if a new machine becomes available which costs $75.00 per period, but which reduces the incremental cost of both services from $0.25 to $0.10. With demand for A and B at 100 units, the new machine offers the opportunity to reduce total costs from $100.00 to $95.00

(i.e., $75.00 + $10.00 + $10.00). Society is clearly better off with the use of the new machine; however, if the company is artificially constrained to price any of its services at the new incremental cost of $0.10, it is difficult for the company to make the economic decision which is best for society.

Q. IF PRICING AT TELRIC LEAVES SHARED AND COMMON COSTS UNRECOVERED, SPECIFICALLY HOW SHOULD PRICES BE SET TO GENERATE THE ADDITIONAL REVENUE REQUIRED TO COVER THESE COSTS?

A. Prices should be set based on market conditions in such a way that the contributions from all services (revenues in excess of incremental costs) are sufficient to cover the shared and common costs of the firm. It is the value of the service to the customer and the market conditions for that service, not cost-based formulas, which will determine how shared and common costs can be recovered in the marketplace. Every network element should provide a contribution toward shared and common costs, based on market conditions. The market place is where prices should be determined. Dr. Alfred Kahn is very emphatic about this point as explained in the following editorial:

> "The FCC should simply get out of the way and leave the decisions to investors and consumers. The commission should call off its cost-allocation rule making, leave the

prices of regulated services where they are and let the market work."[6]

COMPETITION TENDS TO DRIVE PRICES TOWARD COSTS (INCLUDING COMMON COSTS)

Q. DOESN'T COMPETITION DRIVE PRICES TOWARD COSTS?

A. Yes, it does. Competition does not necessarily, however, drive prices to incremental costs.[7] Competition tends to drive prices to a point where all valid business costs are just recovered, and common costs are valid costs of business activity. When competition drives prices toward costs, these common costs are a component of the costs a provider must recover, even in the most competitive of markets.

Q. SHOULD PRICES FOR INTERMEDIATE SERVICES (I.E., SERVICES NOT SOLD TO END USERS SUCH AS UNBUNDLED LOOPS) BE ALLOWED

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[6] Kahn, Alfred E., "Ask Not the Bells for Tolls," *Wall Street Journal*, August 6, 1996, page A14.

[7] If a firm only provides a single product, all of its costs are generally included in a calculation of TSLRIC. Because the majority of the economics literature implicitly or explicitly deals with single product production, a casual reading of parts of the economics literature would lead one to believe that competition drives prices toward TSLRIC; this is true only for a single product firm.

TO MAKE A CONTRIBUTION TO HELP RECOVER THE COMMON COSTS OF A FIRM?

A. Absolutely. In a competitive environment, every activity must be allowed to make a sufficient contribution to help recover the common costs of the firm. Many firms strictly offer business-to-business services, i.e., they only offer intermediate products or services to other firms and do not sell to end users.[8] Many of these firms may have substantial common costs which must be recovered from the prices of the intermediate products or services which they sell to other firms. In general, firms in real markets selling intermediate services have common costs which must be recovered through the prices of the intermediate products or services which they sell to other firms. It is obvious in these instances that providers must obtain a sufficient contribution from each intermediate service or they will be unable to continue in business.

[8] Catalogs and directories exist for "business-to-business" products and services; many of these products are used as components or inputs to produce products for final consumers. Some of the firms which are largely or completely intermediate-products firms are obvious and well known such as Intel, Boeing, McDonnell-Douglas, U. S. Steel, Alcoa Aluminum, or Peabody Coal. However, many other firms which one might consider as final goods producers, such as Beatrice Foods, Detroit Diesel, Kellogg, Phillip Morris, Proctor & Gamble, or Frito Lay, provide relatively few, if any, products to end users. These firms rely on other firms to actually provide products to end users. Certainly, any firm which only provides intermediate services must recover all of its shared costs from those intermediate services.

PRICING SERVICES AT INCREMENTAL COST DOES NOT PRODUCE A PROFIT FOR THE LEC; RATHER, IT GUARANTEES THAT THE LEC WILL NOT RECOVER ITS SHARED INVESTMENTS AND SHARED COSTS.

Q. DOES THE TELECOMMUNICATIONS ACT OF 1996 SPECIFICALLY PROVIDE FOR A REASONABLE PROFIT IN THE PRICING STANDARDS ESTABLISHED FOR ARBITRATION?

A. Yes it does. Section 252(d), in discussing pricing standards, states that "interconnection and network element charges" "may include a reasonable profit." The FCC's recently released First Report and Order (" FCC Interconnection Order") on local competition and related topics also states that prices "will include a reasonable allocation of forward-looking joint and common costs."[9]

Q. DO MR. GILLAN AND DR. KASERMAN ASSERT THAT A PRICE EQUAL TO INCREMENTAL COST OR TSLRIC YIELDS A PROFIT FOR THE LEC?

[9] FCC Interconnection Order at paragraph 672.

A. Yes, as surprising as it may seem, both Dr. Kaserman and Mr. Gillan suggest that a price equal to TSLRIC yields a profit to the LEC.[10] This claim appears to be based on the fact that TSLRIC includes a component for the cost of capital.

Q. IF INCREMENTAL COST OR TSLRIC INCLUDES THE COST OF CAPITAL, DOES A SERVICE PRICE EQUAL TO INCREMENTAL COST OR TSLRIC PRODUCE A PROFIT?

A. No, but contrasting the terms "profit" and "contribution" will help clarify the debate. BellSouth does not make "profits" on individual services or elements because of BellSouth's joint, shared and common costs. Particular services or elements may make a contribution to BellSouth's total costs, and, if enough services or elements make contributions, BellSouth as a firm may make a profit in the accounting sense. Profit is what is left over after all costs have been paid; it is the margin by which total revenues exceed total costs. BellSouth as a firm does not make a profit in the economic sense of the word until it has recovered all its joint and common costs and a return on the capital invested in its operation as a whole.

[10] See for example the direct testimony of Dr. Kaserman at page 22 and the direct testimony of Mr. Gillan at page 31.

It is critical to recognize that an incremental cost calculation only includes the cost of capital (both the cost of debt and equity) for the investments which are directly assignable to the service in question. If each service is priced equal to its incremental cost, then the incremental cost of each service, including a return on the directly assignable capital will be recovered, but the common costs of the firm will remain completely unrecovered, and the firm certainly will not generate a profit.

Consider again the numerical example of the provision of services A and B, I offered in my direct testimony. Products A & B each have a traditional incremental cost per unit of $.25 and with demand of 100 for each service; their total incremental cost is $25 per service. However, to produce either A or B the firm must also spend $50 per period on a machine; in this simple example, the $50 is a common cost of these two products. Of the total $25 incremental cost of service A, assume that $3 represents the cost of equity for a normal return to pay shareholders for the investment in capital equipment which is specifically assignable to the provision of service A. Even when the firm has recovered the $25 of traditional incremental cost for A and the $25 of traditional incremental cost of B, both $25 including a return on investment to shareholders for *that portion* of the capital investment, the firm must still recover an additional $50 in common costs. Without generating $100 in revenue in total, the firm cannot be said to recover its costs and earn even a zero economic profit.

Q. FOR A LEC, DOES PRICING SERVICES AT TRADITIONAL LRIC OR TSLRIC LEAD TO A LOSS?

A. Yes. In contrast to the testimony of Dr. Kaserman and Mr. Gillan, it is completely nonsensical to suggest that any (and implicitly every) multiservice firm can earn a "reasonable profit" simply by pricing its services at traditional LRIC or TSLRIC. LECs have common costs which must also be recovered. By pricing services A and B at incremental cost, my hypothetical firm does not earn a reasonable profit; rather, it suffers an economic loss of $50.

It is noteworthy that Dr. Kaserman and Mr. Gillan do not document or support that AT&T prices its services at marginal cost, LRIC or TSLRIC. If such prices truly generate a "reasonable profit", then one would expect AT&T to provide such documentation. Alternatively, one might expect a promise by AT&T that it will price its services in South Carolina at LRIC or TSLRIC in order to just earn a reasonable profit. In fact, however, Dr. Kaserman and Mr. Gillan do not document nor do they even suggest that such pricing occurs for AT&T services. The reason is obvious; multiservice firms, particularly LECs, face significant shared, joint and common costs which must be recovered by pricing services in excess of LRIC, TSLRIC or TELRIC.

Q. ARE THERE SIGNIFICANT JOINT AND COMMON COSTS IN THE OPERATION OF BELLSOUTH'S NETWORK?

A. Yes, I described the significance of these costs in my direct testimony.

Q. DO THESE JOINT AND COMMON COSTS APPEAR IN INCREMENTAL COST MEASURES?

A. No. Incremental cost measures like LRIC, TSLRIC and the FCC's proposed TELRIC are not intended to and do not account for joint and common costs because those costs are not incremental. Thus, although TSLRIC, for example, allows for a return on the capital investments assignable to a particular service, it does not allow any contribution to shared costs or any return on capital employed that is not assignable to a particular service.[11]

Q. ARE JOINT AND COMMON COSTS REAL COSTS?

A. Yes, these are costs that are necessarily incurred in order for BellSouth to remain in business, as they are incurred by every other multiproduct firm. In fact, because there are substantial joint and common costs, BellSouth can provide serv-

[11] The TELRIC pricing methodology requires separate consideration of joint and common costs.

ices more efficiently. BellSouth, however, cannot ignore these costs. If these costs are not recovered, the services or elements that benefit from the sharing facilities and costs will disappear from BellSouth's offerings.

Q. HAS THE FCC RECOGNIZED THAT JOINT AND COMMON COSTS ARE REAL COSTS THAT MUST BE RECOVERED BY BELLSOUTH IN THE PRICES OF ITS UNBUNDLED ELEMENTS?

A. Yes. The FCC recognized in its Order in Docket 96-98 at Paragraph 696 that joint and common costs must be recovered in the prices for unbundled element.

Q. IN THE NEW TELECOMMUNICATIONS ENVIRONMENT, WILL IT BECOME INCREASINGLY DIFFICULT FOR LECS TO RECOVER THE JOINT AND COMMON COSTS OF THEIR NETWORKS FROM RETAIL SERVICES LIKE VERTICAL SERVICES?

A. Yes. For example, if under the FCC Interconnection order, vertical services functionalities are interpreted to be included as part of the switching function, they would be available to any CLEC wishing to purchase unbundled switching capabilities. If joint and common costs are simply allocated to retail services rather than allowing some portion of their recovery through the underlying network elements, competitors purchasing the unbundled elements will be able to

price substantially below BellSouth's retail costs. Competitors purchasing unbundled elements will have limited common network costs of providing the service because they can simply purchase it from BellSouth. Thus, allocating B's joint and common costs to retail services means that only BELLSOUTH's retail customers will be asked to pay for the joint and common costs which provide value to both BellSouth's customers and CLECs. This puts BellSouth at a competitive disadvantage and BellSouth is simply unlikely to recover its joint and common costs.

Q. WHAT WOULD BE THE EFFECT OF DENYING RECOVERY OF JOINT AND COMMON COSTS IN THE PRICES OF UNBUNDLED ELEMENTS?

A. There would be two effects. First, new firms considering undertaking the risk of entering on a facilities basis would be aware that successful entry would yield, at most, recovery of the incremental costs of entry, without the possibility of contribution towards the firm's joint and common costs and without any reward for the risk of entering. These firms would be unlikely to undertake the risks of entry.

Second, BellSouth, faced with receiving no contribution from the unbundled network elements towards its joint and common costs would have to balance the returns on other investments that could yield at least some contribution through

investing in new elements and its carrier of last resort obligations. Just as the incentives created by such pricing would make new entrants less likely to enter on a facilities bases, they would make BellSouth less likely to invest in facilities. To the extent BellSouth may be constrained by its legal obligations to invest in new facilities, pricing without recovery of joint and common costs is unfair, and likely unsustainable.

Q. HOW SHOULD JOINT AND COMMON COSTS BE ALLOCATED?

A. The fundamental issue, of course, is not allocation but recovery. In competitive markets, firms recover joint and common costs by pricing above incremental costs to the extent demand permits.

DR. KASERMAN'S CLAIMS REGARDING COMMON COSTS ARE UNSUPPORTED

Q. DR. KASERMAN STATES (AT PAGE 24): "SOME RECENT EVIDENCE SUGGESTS THAT THE MAGNITUDE OF COMMON COSTS IN THIS INDUSTRY HAVE BEEN GREATLY EXAGGERATED, PARTICULARLY AMONG UNBUNDLED NETWORK ELEMENTS." WHAT EVIDENCE DOES DR. KASERMAN CITE TO SUPPORT THIS CLAIM?

A. Dr. Kaserman cites an affidavit by Baumol, Ordover and Willig, filed on behalf of AT&T stating: "We understand that the portion of forward-looking costs that is unattributable to particular network elements is likely to be small. ..." To the extent that there is any recent evidence, Dr. Kaserman has not revealed it. His cite doesn't address the claim of cost estimates which are "greatly exaggerated." And one can hardly consider a statement on behalf of AT&T stating that the authors "understand" something about the nature of costs to represent new "evidence." Their understanding could be based on conversations with AT&T employees. Such claims are not credible in part because UNEs are by definition components which become new services; UNEs are not some radical new product.[12] They will be offered for sale to customers like any other service; they are simply services which have been unbundled and did not previously exist. LECs have unbundled portions of services in the past and it did not seem to cause common costs to somehow disappear.

The existence of common costs or economies of scope are well known in the telecommunications industry. It is because of these common costs that the entire issue of cost allocation or fully distributed costs or the full allocation of costs has received so much attention in the industry at different points in time. Economists are fond of describing why allocations of common costs are inappropriate

[12] The proportion of costs which would be common under a TELRIC calculation would be smaller than under a calculation for traditional services. However, significant common costs will still remain.

and why these costs should be recovered on the basis of demand information rather than simple cost allocation rules.[13] Without common costs in telecommunications there would, of course, be nothing to allocate; the entire issue of fully distributed costs would simply not exist.

Q. BESIDES THE AT&T FILING WITH THE FCC, DOES DR. KASERMAN SUPPORT HIS CLAIM THAT COMMON COSTS ARE LIKELY TO BE SMALL?

A. No, Dr. Kaserman's testimony on the implied absence of common costs appears to be based on speculation and conjecture. His claim - that the incremental costs of UNEs will somehow absorb all common costs and lead to a firm which has negligible common costs - is simply assertion without theoretical foundation or factual basis.

Q. IS DR. KASERMAN CONTRADICTORY IN HIS CLAIMS IN THIS REGARD?

[13] The citations from the economics literature are numerous and include articles authored by William Baumol, whom Dr. Kaserman cites in support of his position.

A. Yes. Dr. Kaserman discusses his concerns for BellSouth's monopoly power in local markets yet he simply asserts that BellSouth will have insignificant common costs because it is not a natural monopoly. At one point in his testimony he notes the tradition of cross-subsidies in telecommunications yet later he suggests that cross-subsidies and universal service should be disregarded in his pricing proposals.

Dr. Kaserman admits "ILECs currently sell many services and products to end users that are priced well in excess of costs."[14] Instead of taking this as a sign of the magnitude of the joint and common costs of the LECs, Dr. Kaserman concludes that "as a result, it is not at all clear that pricing these competitively-important arrangements, elements and functions at TSLRIC will create an overall revenue shortfall." Common costs clearly do exist. Even if in theory common costs were small or did not exist, in practice it would be difficult or impossible to assign all costs to elements and services. In practice, some unattributable costs would remain.

[14] Direct testimony at page 24. One must assume that he is referring to incremental or marginal cost at this point.

ON AVERAGE, FIRMS IN COMPETITIVE INDUSTRIES RECOVER THEIR HISTORICAL INVESTMENTS

Q. DO FIRMS IN COMPETITIVE INDUSTRIES PRICE SERVICES EQUAL TO THEIR EMBEDDED COSTS?

A. No, not necessarily. Firms in competitive industries may, at any point in time price services above, below, or equal to their embedded costs or historical costs. Such firms will generally not price services below forward-looking incremental costs, but the degree to which prices exceed incremental costs will be based on market considerations at the time.

Q. DOES THIS MEAN THAT SUCH FIRMS GENERALLY DO NOT RECOVER THEIR HISTORICAL INVESTMENTS?

A. No. Obviously, firms on average must recover their historical costs and earn a normal accounting profit (a zero economic profit). No firm would willingly enter an industry or engage in an activity if it expected that it would not recover its investment. Some firms do sustain losses and they generally go out of business. Other firms earn above-average accounting profits (positive economic profits). In fact, it is the full costs of the *least* efficient firm in the market which actually

survives which most closely corresponds to the price in the market. This marginal firm will just barely earn a zero economic profit and stay in business in the long run.

"Profit" is by nature a residual concept. It is what is left over after all costs have been paid; it is the margin by which total revenues exceed total costs. On average, firms must expect to earn at least an average accounting profit or firms will not enter and produce; i.e., on average firms must recover their historical costs.

Logically, to take regulatory action which would preclude a firm from recovering its historical costs would seem to require a significant probability that under different circumstances the firm would have been allowed to earn a profit much greater than average. In particular, it would seem that one must carefully consider a regulatory policy which precludes recovery of historical costs, when absent regulation, the firm would have a reasonable opportunity for recovery of such costs.

THE COMMISSION SHOULD CONSIDER HISTORICAL COSTS WHEN ESTABLISHING PRICES FOR UNES AND INTERCONNECTION SERVICES

Q. HOW ARE HISTORICAL COSTS RELEVANT TO THE PRICING OF INTERCONNECTION AND UNES?

The recovery of past uncompensated expenditures may be precluded from the ensuing competition in the local exchange market. These unrecovered costs are the product of the franchise monopoly agreement under which BellSouth operated for most of its history. Under this agreement, BellSouth was assured a reasonable opportunity for recovery of the costs of prudently incurred investments through rates charged to customers. In order to keep these rates low, depreciation lives were artificially extended beyond the economic lives of the investments. The return promised to investors was not allowed to be large enough to compensate for the risk of long depreciation lives. These factors served to maintain low telephone rates and to accomplish public universal service objectives. In addition, there is a need to compensate BellSouth for its present unrecovered costs which are not a part of forward-looking costs.

Q. SHOULD THE COMMISSION ALLOW BELLSOUTH A REASONABLE OPPORTUNITY TO RECOVER PAST UNCOMPENSATED COSTS IN AN ENVIRONMENT OF LOCAL SERVICE COMPETITION?

A. Yes. For the purpose of this answer, let's assume that BellSouth incurred the costs in question prudently in accordance with the discharge of its duties and responsibilities under the regulatory compact in place at the time these costs were incurred. This assumes that the Commission has judiciously monitored the capital outlays of BellSouth in accordance with the "used and useful" criterion.

The first point to be made with respect to this issue is that it transcends the question of what may be considered fair or equitable to BellSouth. Indeed, how the Commission addresses this issue will have profound efficiency implications that will be felt far into the future. Should the Commission simply disavow the existence of unrecovered historical costs, it will have indicted its own record of performance in carefully monitoring the capital outlays of BellSouth, and breached its commitment to BellSouth in failing to allow for recovery of all "prudently incurred" costs.

It is this latter possibility that is a particular cause for concern, especially in light of the credibility of this Commission's commitments to alternative regulation plans (*i.e.*, the Consumer Price Protection Plan). BellSouth's performance under

incentive regulation is inextricably tied to the firm's belief in the credibility of the Commission's commitment. BellSouth has no incentive to seek out opportunities to reduce operating costs if it believes the Commission will merely usurp any realized cost savings and pass them on to consumers in the form of lower prices. BellSouth will also have limited incentives to bear risk associated with investment in network infrastructure if it believes the Commission will expropriate the returns from this investment. Hence, when BellSouth perceives that the Commission's commitment is non-credible (the Commission cannot be relied upon to deliver what was promised), incentive regulation will differ from rate-of-return regulation in name only.

Q. ARE THERE OTHER PROBLEMS OF ECONOMIC INEFFICIENCY WHICH ARISE FROM FAILING TO ALLOW FOR THE RECOVERY OF UNCOMPENSATED PAST COSTS?

A. Yes, there are. Failure to allow recovery of unrecovered historical costs will increase the risk of investing in the firm for two reasons. First, as mentioned above, the credibility of the Commission will be questioned and cause investors to be wary of future commitments made by the Commission. Second, the financial viability of BellSouth will be hindered thereby causing investors to demand a higher return on their investment. This leads to either an unnecessary increase in the cost of capital or a shortage of investment funds.

It is important to note that in the end it is the consumer who will likely absorb the resulting economic inefficiencies. Such inefficiencies will be manifested in higher prices, poor quality of service, and lack of innovation.

Q. HOW SHOULD UNCOMPENSATED COSTS OF PAST OBLIGATIONS BE RECOVERED?

A. First, it should be recognized that such costs are essentially a form of common costs and should be treated as such. An economically appropriate means of recovering uncompensated historical costs is through a contribution from unbundled network elements which are sold to competitors, just as services make a contribution. In doing so, the vertically integrated incumbent LEC will be charging competitors the same price for inputs which it implicitly charges itself. The primary benefit is that such a markup on unbundled network elements is competitively neutral and will only serve to promote the competitive process.

Q. PLEASE EXPLAIN HOW THE CONTRIBUTION FROM UNBUNDLED NETWORK ELEMENTS MIGHT BE CONSIDERED.